

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN**

**REPORT ON FINANCIAL STATEMENTS
(with required supplementary information)**

YEAR ENDED SEPTEMBER 30, 2004

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INDEPENDENT AUDITORS' REPORT

Michigan State Hospital Finance Authority
Lansing, Michigan

October 19, 2004

We have audited the accompanying basic financial statements of the Michigan State Hospital Finance Authority, a proprietary component unit of the State of Michigan, as of and for the year ended September 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Michigan State Hospital Finance Authority as of September 30, 2004, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 19, 2004 on our consideration of the Michigan State Hospital Finance Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 2 and 3 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Maner, Costerisan & Ellis, P.C.



Jennifer M. Granholm
Governor

STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

Jay B. Rising
State Treasurer

Management's Discussion and Analysis

We are pleased to present the financial statements of the Michigan State Hospital Finance Authority. The Michigan State Hospital Finance Authority (the "Authority") was organized under Act 38 of the Michigan Public Acts of 1969. The mission of the Authority is to provide low cost capital financing to non-profit providers of health care services that participate in any phase of the continuum of health care. It is the vision of the Authority to be the first choice of capital financing sources for all health care providers in the State of Michigan.

The Authority is an agency of the Michigan Department of Treasury and is housed in the Bureau of Bond Finance. The Authority is governed by a seven-member board appointed by the Governor with the advice and consent of the Senate. The Authority is a proprietary component unit of the State of Michigan.

The Authority issues or sells tax-exempt bonds in the national public finance markets. The proceeds from these bonds are then lent to providers of health care services to finance capital projects. Short term financing is also available through the Authority's Health Care Equipment Loan Program (HELP). This is a pooled loan program, which provides financing for equipment, small capital projects and renovations.

The following is a condensed summary of financial information for the years ended September 30, 2004 and 2003, respectively.

Condensed Financial Information

Category	2004	2003
Total Assets	\$5,875,853	\$5,946,612
Total Liabilities	\$458,531	\$451,784
Total Net Assets	\$5,417,322	\$5,494,828
Operating Revenues	\$951,492	\$969,757
Operating Expenses	\$1,063,934	\$1,175,219
Operating Income (Loss)	\$(112,442)	\$(205,462)
Nonoperating Revenue	\$34,936	\$261,590
Change in Net Assets	\$(77,506)	\$56,128
Ending Net Assets	\$5,417,322	\$5,494,828

Fees charged to its clients fund the operations of the Authority. The fees are based on the outstanding debt of its clients. This year the reduction in principal outstanding was greater than the new bonds issued for the fiscal year. This resulted in a reduction in fee revenue for 2004.

Overall, operating expenses decreased again for fiscal year 2004. Major reductions were experienced in rent for space, moving expenses, Attorney General charges and the expense related to the publication of notices. Salaries and benefits were also down due to mandatory furlough days without pay, which was in place for fiscal year 2004. The Authority was moved to a temporary location in the Treasury Building while renovation was being completed on its permanent home located on the first floor of the Treasury Building in Lansing, Michigan. There was no rent being charged to the Authority while it was at its temporary location. The Authority is now at its permanent location and rent for space charges will resume for the fiscal year 2005. Effective for fiscal year 2004, the Authority board shifted the expense related to the publication of notices from the Authority to the hospital client.

Nonoperating revenue is probably the most significant factor relating to the loss of \$77,506. Compared with last year there was a decrease of 87%. The investments of the Authority, which were purchased several years ago at attractive rates, are now maturing. The weighted average rate of the investments that matured this year was 4.9%. The new investment purchases to replace the matured investments are at a much lower rate with a weighted average rate of 1.3%. The income flow from these investments materially affected the investment income for fiscal year 2004. Also, last year investments were sold and a gain was realized on these sales. These sales were to fund the fee rebate of \$5.0 million to hospital clients.

The financing activity of the Authority was somewhat diminished for 2004. The Authority issued over \$330 million in debt this past fiscal year with interest rates varying from 0.99% to 5.50%. Two of the clients served this year were new clients of the Authority.

In fiscal year 2004, with the completion of the Authority's physical move to its permanent home, the Authority was incorporated in the Bureau of Bond Finance. The Bureau of Bond Finance houses several bonding authorities and the intent is to provide services to all authorities with a greater economy of scale. Management expects the operations of the MSHFA will benefit from this setting and ultimately will see full funding of its operations with no increase in charges to its clients.

MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
STATEMENT OF NET ASSETS
SEPTEMBER 30, 2004

ASSETS:

Current assets:

Cash and cash equivalents (Notes 1 and 2)	\$ 460,685
Amounts due from primary government	40,246
Investments - operations (Notes 1 and 2)	1,794,006
Other current assets:	
Investment income receivable	33,720
Administrative fees receivable	558,941
Due from H.E.L.P. issues (Note 3)	380,000
Total other current assets	<u>972,661</u>
Total current assets	<u>3,267,598</u>

Noncurrent assets:

Restricted assets (Amounts due hospitals Notes 1 and 2):

Investments	119,300
Investment income	5,306
Total restricted assets	<u>124,606</u>

Unrestricted:

Investments - operations (Notes 1 and 2)	<u>2,465,303</u>
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Capital assets (Note 4):

Property, plant and equipment	64,114
Less accumulated depreciation	<u>(45,768)</u>
Total capital assets	<u>18,346</u>
TOTAL ASSETS	<u><u>\$ 5,875,853</u></u>

LIABILITIES:

Current liabilities

Accounts payable and other liabilities - due hospitals	<u>\$ 31,006</u>
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Noncurrent liabilities

Employee compensated absences and sick leave (Note 5)	333,925
Amounts due hospitals (Note 1)	93,600
Total noncurrent liabilities	<u>427,525</u>
Total liabilities	<u>458,531</u>

NET ASSETS:

Invested in capital assets	18,346
Unrestricted	<u>5,398,976</u>
Total net assets	<u>5,417,322</u>
Total liabilities and net assets	<u><u>\$ 5,875,853</u></u>

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
STATEMENT OF ACTIVITIES
YEAR ENDED SEPTEMBER 30, 2004**

	<u>Expenses</u>	<u>Charges for Services</u>	<u>Net (expense) revenue and change in net assets</u>
<u>Functions/Programs</u>			
Primary government:			
Business type activities:			
Hospital Finance Authority	\$ 1,063,934	\$ 951,492	\$ (112,442)
General revenues:			
Unrestricted investment income			34,936
CHANGE IN NET ASSETS			(77,506)
NET ASSETS, beginning of year			5,494,828
NET ASSETS, end of year			\$ 5,417,322

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
YEAR ENDED SEPTEMBER 30, 2004**

OPERATING REVENUES:

Authority fees	\$ 951,492
	\$ 951,492

OPERATING EXPENSES:

Personal services	635,001
Purchased professional and technical services	388,954
Purchased property services	2,923
Other purchased services	18,974
Supplies	10,123
Depreciation	7,959
	7,959

Total operating expenses	1,063,934
	1,063,934

Operating loss	(112,442)
	(112,442)

NONOPERATING REVENUES:

Investment income	34,561
Other income	375
	375

Total nonoperating income	34,936
	34,936

CHANGE IN NET ASSETS	(77,506)
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NET ASSETS:

Beginning of year	5,494,828
	5,494,828
End of year	\$ 5,417,322
	\$ 5,417,322

MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
STATEMENT OF CASH FLOWS
YEAR ENDED SEPTEMBER 30, 2004

CASH FLOWS FROM OPERATING ACTIVITIES:

Receipts from customers	\$ 979,224
Payments to suppliers	(967,675)
	<hr/>
Net cash provided by operating activities	11,549
	<hr/>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:

Transfers to other funds	(380,000)
Advances from other funds	440,000
	<hr/>
Net cash provided by noncommittal financing activities	60,000
	<hr/>

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:

Acquisition of capital assets	(7,566)
	<hr/>

CASH FLOWS FROM INVESTING ACTIVITIES:

Proceeds from sale and maturities of investment securities	3,629,400
Purchase of investment securities	(3,971,141)
Interest and investment income (non program)	179,616
	<hr/>
Net cash used by investing activities	(162,125)
	<hr/>

NET DECREASE IN CASH AND CASH EQUIVALENTS

(98,142)

CASH AND CASH EQUIVALENTS:

Beginning of year	558,827
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End of year	\$ 460,685
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RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES:

Operating income (loss)	\$ (112,442)
Adjustments to reconcile operating income (loss) to net cash provided (used) by operating activities:	
Depreciation expense	7,959
Changes in assets and liabilities:	
Amounts due from primary government	81,553
Accounts receivable	27,733
Accounts payable and other liabilities	(24,441)
Increase in compensated absences payable	31,187
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Total adjustments	123,991
	<hr/>
Net cash provided by operating activities	\$ 11,549
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**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Michigan State Hospital Finance Authority (the "Authority") was organized under Act 38 (the "Act") of the Michigan Public Acts of 1969, as amended to facilitate the ability of nonprofit, non-public health care corporations and facilities (the "facilities") to obtain financing and refinancing for capital improvements. The Authority consists of seven members including a chairperson and four public members, appointed by the Governor with the advice and consent of the Senate, and two ex-officio members (the State Treasurer and the Director of the Department of Community Health). The Authority functions independent of the State Treasurer who, as agent for the Authority, may not commingle funds and must maintain a separate bank account for the Authority. The Authority is a proprietary component unit of the State of Michigan (the "State") and is reported as such in the State of Michigan Comprehensive Annual Financial Report (SOMCAFR).

The Act empowers the Authority to issue bonds for the purpose of making related loans to facilities. The Authority issues bonds for facility equipment loans through the Health Care Equipment Loan Program (H.E.L.P.) and issues revenue bonds, including insured revenue bonds, and mortgage bonds for other capital needs of the facilities. Eligible facilities obtain funds from the Authority for specific capital projects by arranging for the Authority to offer bonds for sale. Each facility signs a note and enters into a loan agreement with the Authority for payment of the note. Such bonds are payable with monies received from each respective facility, as described below, and not from the general assets of the Authority. In general, loans made under H.E.L.P. are secured by the financed equipment.

All bonds are limited obligations of the Authority and are not obligations of the State. The State is not liable for payment of the bonds. The bonds are payable by the Authority, through designated trustees, solely from funds received from each participating facility in payment of the Authority's note and from investment earnings, undisbursed bond proceeds and other funds of each participating facility retained by the trustees on a bond issue-specific basis. Certain of the revenue and mortgage bonds are guaranteed by a bond insurance policy or a letter of credit if payments under the note and pledged assets are not sufficient to pay the bonds.

Participating facilities share the administrative costs of the Authority in an amount related to the principal balances of the respective outstanding bonds.

The accompanying financial statements have been prepared in accordance with criteria established by the Governmental Accounting Standards Board Statements No. 14 and No. 39. These criteria include oversight responsibility, accountability for fiscal matters, scope of public services and special financing relationships.

In July 2002, an executive order was issued which combined the Authority's administrative staff with the administrative staff of several similar authorities into a single work unit under the direction and supervision of the State Treasurer.

MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

B. Financial Statements

The financial statements (i.e., the statement of net assets, statements of activities, revenues, expenses and changes in net assets and statement of cash flows) report information on all activities of the government. The Authority is considered a business type activity and has no component units.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. *Direct expenses* are those that are clearly identifiable with a specific function or segment. *Program revenues* include charges to customers who use, or directly benefit from services or privileges provided by a given function or segment.

C. Measurement Focus, Basis of Accounting and Financial Statement Presentation

The Authority is accounted for as a proprietary fund. A proprietary fund is used to account for operations:

- a) that are financed and operated in a manner similar to private business enterprises - where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or
- b) where the governing body has decided periodic determination of revenues and expenses and net income is appropriate for capital maintenance, public policy, management control, accountability or other purposes.

Proprietary funds are reported using the “economic resources measurement focus” and the “accrual basis of accounting”. Revenues are recognized when earned and expenses are recognized when the materials, services, or benefits are received. Service fees and other fees and charges are recorded as income when earned, and the associated administrative expenses are recorded as incurred.

Designated trustees maintain separate accounting records pertaining to each individual bond issue for each participating facility. Assets managed by the trustees for each facility are restricted for payment of bond principal and interest and approved construction expenditures except for certain investment income which may be returned to the facility. None of the assets or liabilities held by the trustees are reflected in the Authority's financial statements, as more fully described in Note 7.

Bond proceeds are retained by the trustees to fund interest costs and principal payments during the period of construction. After the construction period, interest and principal payments are funded by regular loan payments from the facilities.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in both the government-wide and proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to the same limitation. The Authority has elected not to follow subsequent private-sector guidance.

Amounts reported as *program revenues* include charges to customers, services, or privileges provided. Likewise, general revenues include unrestricted investment income.

Proprietary funds distinguish *operating* revenues and expenses from *nonoperating* items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the Authority are charges to customers for services. Operating expenses of the Authority include the cost of services, administrative expenses, and the depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

D. Assets, Liabilities, and Net Assets

Cash and Cash Equivalents: Cash and cash equivalents include deposits with financial institutions.

Cash and Investments: The Authority's deposits and investments are held in a fiduciary capacity by the State Treasurer. The Act restricts investments to obligations of the State or U.S. government, obligations of which the principal and interest are guaranteed by the State or U.S. government, certificates of deposit of a bank which is a member of the Federal Reserve System or a savings and loan association which is a member of the Federal Home Loan Bank System, certain classifications of commercial paper, U.S. government repurchase agreements, bankers' acceptances of U.S. banks, mutual funds composed of investment vehicles that are legal for direct investment by the Authority, and other obligations approved by the State Treasurer.

Investments are stated at fair value.

The Act requires all deposits of the Authority to be secured by obligations of the United States or of the State. The market value of these obligations must at all times be equal to or greater than the amount of the deposits of the Authority, and all banks and trust companies are authorized to give such security for such deposits.

Accounts receivable – Accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a provision for bad debt expense when necessary and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. Changes in the valuation allowance have not been material to the financial statements and no allowances are currently deemed necessary.

Capital Assets: Capital assets include office equipment. Capital assets are defined by the Authority as assets with an initial individual cost of more than \$1,000 and an estimated useful life in excess of one year.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Concluded)

D. Assets, Liabilities, and Net Assets (Concluded)

Such assets are recorded at historical cost. The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized. Capital assets are depreciated using the straight line method over the following estimated useful lives:

<u>Asset</u>	<u>Years</u>
Office equipment	7
Computer equipment	5

Compensated Absences: Vacation, banked leave time and sick pay are recorded as expenses at the time the benefit is earned by the employee taking into consideration maximum contractual amounts.

Amounts Due Trustees: The Authority holds state and local government securities which by their nature could not be transferred to the trustees. When these investments mature, the funds will be remitted to the appropriate trustees. Therefore, these investments are recorded as current and noncurrent assets of the Authority, and a related liability is recorded to recognize the Authority's obligation to transfer the assets to the trustees. Interest earnings of these investments are paid by the Authority to the appropriate trustees.

Estimates: The process of preparing financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

NOTE 2 - DEPOSITS AND INVESTMENTS

A. General Information

GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires certain disclosures regarding policies and practices with respect to deposits and investments and the custodial credit risk associated with them.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 2 - DEPOSITS AND INVESTMENTS (Continued)

A. General Information (continued)

Deposits

In accordance with Statement No. 3, deposits are classified into three categories of credit risk as follows:

Category 1: Insured or collateralized with securities held by the entity or by its agent in the entity's name.

Category 2: Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name.

Category 3: Uncollateralized (This includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the entity's name.)

Investments

In accordance with Statement No. 3, investments are also classified into three categories of credit risk, as follows:

Category 1: Insured or registered, or securities held by the entity or its agent in the entity's name.

Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name.

Category 3: Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount of any repurchase agreement that exceeds the market value of the underlying securities.)

B. Deposits

At September 30, 2004, the carrying amount and the bank balance of the Authority's deposits was \$460,685. The September 30, 2004, balance was covered by federal depository insurance or collateral held with the Authority's agent in the Authority's name and accordingly classified in GASB credit risk category 1.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 2 - DEPOSITS AND INVESTMENTS (Concluded)

C. Investments

The following table shows the fair values of investments, by investment type and in total at September 30, 2004:

	GASB 3 Category			Total Reported amount and fair value
	#1	#2	#3	Not Categorized
Government securities	<u>\$ 119,300</u>	<u>\$</u>	<u>\$ 4,259,309</u>	<u>\$</u>
Included on the statement of net assets:				
Current investments:				
Unrestricted				\$ 1,794,006
Noncurrent investments:				
Unrestricted				2,465,303
Restricted				<u>119,300</u>
				<u>\$ 4,378,609</u>

NOTE 3 - DUE FROM H.E.L.P. ISSUES

The Authority has advanced funds for the purpose of paying the issuance costs related to the Health Care Equipment Loan Program (H.E.L.P.) bond issues. The proceeds from the H.E.L.P. bond issues are loaned to qualifying hospitals for hospital equipment. These advances will be repaid to the Authority during the H.E.L.P. loan repayment period. As of September 30, 2004, \$380,000 was advanced by the Authority.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 4 – CAPITAL ASSETS

As of September 30, 2004 depreciable assets consisted of the following:

	Beginning balance	Increase	Decrease	Ending balance
Office equipment and computers	\$ 67,622	\$ 7,566	\$ (11,074)	\$ 64,114
Less accumulated depreciation	<u>(48,883)</u>	<u>(7,959)</u>	<u>11,074</u>	<u>(45,768)</u>
Office equipment - net	<u>\$ 18,739</u>	<u>\$ (393)</u>	<u>\$ -</u>	<u>\$ 18,346</u>

All depreciation expense has been charged to the Authority's sole activity. Executive Order 2001-3 transferred the ownership of the Authorities computer equipment to the Department of Information Technology (DIT). At September 30, 2004, the Authority has recorded \$40,650 of computer equipment, \$28,448 of related accumulated depreciation and \$4,607 in depreciation expense on DIT computer equipment.

NOTE 5 - COMPENSATED ABSENCES

Plan Descriptions

Employees accumulate annual leave (vacation) balances to a maximum ranging from 240 to 316 hours. They receive a 100% termination payment upon separation based upon their final rate of pay. Employee sick leave balances accumulate without limit. Termination payments are made only upon separation from State service and only to employees hired prior to October 1, 1980. Payments at retirement or death are based on 50% of the employee's sick leave accumulation times their final rate of pay. When separating for any other reason, employees are paid a percentage of their unused sick leave which increases from 0 to 50% depending upon the balance of their sick leave hours. Effective October 2003, employees continue to work their regular schedules. Each employees biweekly pay is reduced by up to 4 hours of pay. The unpaid time is credited to the employees bank leave time account and can be used for unpaid time off or it can accumulate up to 104 hours a year. Unused accumulated banked leave time is paid as an employer contribution to a 401(k) plan when the employee separates from service.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 5 - COMPENSATED ABSENCES (Concluded)

Accounting Policy

The Authority has accrued liabilities for compensated absences as required by the GASB. Annual leave is valued at 100% of the balance plus the State's share of social security and retirement contributions. Sick leave is valued, as explained, at 0% to 50% plus the State's share of social security and retirement contributions. Banked leave time is valued at the unused accumulated hours at year end. The pay rates in effect as of October 1, 2004 are used. As of September 30, 2004, the Authority has an annual leave compensated absences liability in the amount of \$78,956, a sick leave compensated absences liability in the amount of \$237,371 and a bank leave time compensated absence liability in the amount of \$17,598.

NOTE 6 - EMPLOYEE BENEFITS

The employer's share of life, health, optical, dental and long-term disability insurance premiums are charged by the State of Michigan to the Authority biweekly based on each employee's selected coverage.

Defined Benefit Pension Plan

The Authority's employees hired prior to April 1, 1997 are enrolled in a noncontributory defined benefit plan through the State Employees' Retirement System (the "Plan") upon meeting certain eligibility requirements. The Plan provides for retiree pension and other postretirement benefits such as, dental, vision, and major medical coverage. The cost of the pension is currently funded, while the costs of the other postretirement benefits are on a pay as you go basis. The costs of these benefits are allocated to the Authority as a percentage of payroll.

The Authority's covered payroll, which was also the total payroll, was approximately \$344,000, \$370,000, and \$450,000, for the years ended September 30, 2004, 2003 and 2002, respectively. The Authority's actuarially determined contribution requirements, and the contributions actually made, were approximately \$94,000, \$88,000, and \$90,000 representing 27%, 24%, and 20% of annual covered payroll for the years ended September 30, 2004, 2003 and 2002, respectively.

The State Legislature establishes the extent to which the employer and the employees are required to make contributions and establishes the benefit provisions for the Plan. Additional detail and data regarding the Plan description, vesting, and eligibility requirements, actuarial cost methods and assumptions, funding requirements, accounting policies and ten year historical trend information is provided in the SOMCAFR and the Plan's detailed financial report issued by the Office of Retirement Systems. Those reports may be obtained by writing the Department of Management and Budget, Office of Retirement Systems, 7150 Harris Drive, P.O. Box 30171, Lansing, Michigan 48909 or by calling (517) 322-6262.

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 6 - EMPLOYEE BENEFITS (Concluded)

Defined Contribution Pension Plan

The State Employees' Defined Contribution Retirement Plan (the Plan) was established to provide benefits at retirement to employees of the State who were hired after March 31, 1997 and to those members of the State Employees' Retirement (defined benefit) System, who elect to transfer to the plan. The Plan is administered by the State Treasurer. The State is required to contribute 4% of annual covered payroll. The State is also required to match employee contributions up to 3% of annual covered payroll. Plan provisions and contribution requirements are established and may be amended by the Legislature. The Authority transferred approximately \$23,200 to the State for its employer contribution. Employee contributions to the Plan were not significant.

Deferred Compensation Plan

Employees may also participate in a Section 457 plan and a 401(k) plan. Neither the Authority or the State makes an employer contribution to these plans. The assets and liabilities of the Section 457 and 401(k) plans are reported in the SOMCAFR and are not reported in the Authority's balance sheet.

NOTE 7 - UNRECORDED LIMITED OBLIGATION DEBT

The Authority has certain bonds outstanding. The trustee, fiscal agent, registrar, and paying agent functions for the defeased bonds are performed by an Authority designated trustee. Because these obligations are, in substance, debts of other entities, the liabilities and related assets are not reflected in the Authority's financial statements.

The Authority has defeased, in substance, certain bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. Economic gains and accounting gains and losses upon in-substance defeasance inure to the benefit of the facility for which the bonds were issued and accordingly are not reflected in the Authority's financial statements.

The defeased, defeased and total outstanding bonds as of September 30, 2004 follows:

Defeased	\$ 4,093,523,943
Defeased	<u>1,275,340,000</u>
Total outstanding	<u><u>\$ 5,368,863,943</u></u>

**MICHIGAN STATE HOSPITAL FINANCE AUTHORITY
A COMPONENT UNIT OF THE STATE OF MICHIGAN
NOTES TO FINANCIAL STATEMENTS**

NOTE 8 - OPERATING LEASE

The Authority recently relocated to a State of Michigan governmental building. Rent is not being charged by the State pending completion of the building remodeling, at such time the Authority expects to enter into a rental agreement with the State of Michigan. As of September 30, 2004, completion of the building remodeling is pending.

NOTE 9 - TRANSACTIONS WITH OTHER STATE AGENCIES

The Authority has entered into an agreement to provide the Michigan Higher Education Facilities Authority (MHEFA) (a similar authority for non-profit colleges and universities also under the Department of Treasury) certain administrative services. The contract amount received, \$30,000 for the year ended September 30, 2004, has been reported as an offset to operating expense. The Authority is also charged by various state agencies and departments for certain accounting, auditing, legal and cash management services. These fees were approximately \$398,600 for the year ended September 30, 2004. As of September 30, 2004, no amounts were due from or to other state agencies or departments for these services.

NOTE 10 - RISK MANAGEMENT

The Authority's risk management is provided through the State of Michigan. The State has elected not to purchase commercial insurance for many of the risks of losses to which it is exposed. The State is self-insured for most general liability and property losses, portion of its employee insurance benefit and employee bonding programs, automobile liability, and workers' compensation and unemployment compensation claims. The State has established two internal service funds, the Risk Management Fund and the State Sponsored Group Insurance Fund, to account for certain aspects of the risk management program. Additional detail and other data on the State's risk management program are provided in the SOMCAFR.

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

Michigan State Hospital Finance Authority
Lansing, Michigan

October 19, 2004

We have audited the basic financial statements of the Michigan State Hospital Finance Authority, a proprietary component unit of the State of Michigan, as of and for the year ended September 30, 2004, and have issued our report thereon dated October 19, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statements amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Authority and management and is not intended to be and should not be used by anyone other than these specified parties.